

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

98

1 Dr. Cornell's plan is similar to that proposed by
2 Pacific in this proceeding; is that correct?

3 A Yes.

4 Q And as I understand it, the important
5 similarities between the two proposals are the
6 elimination of the current price cap index and its
7 replacement with stable rates, and secondly, a
8 substantial reduction in regulation of competitive
9 services. As I understand it, those are the points of
10 agreement you see between the two proposals, sir?

11 A Those are the two listed in that sentence.
12 The sentence that follows the one you have been pointing
13 to mentions others.

14 Q Thank you.

15 You go on in the next paragraph, sir, to
16 discuss one of Dr. Cornell's specific recommendations,
17 that of pricing essential input at cost. Do you see
18 that discussion, sir?

19 A I do see it.

20 Q As I understand it, you believe that
21 Dr. Cornell's recommendation would hold the reforms that
22 have been recommended by Pacific hostage to a favorable
23 outcome on this issue of pricing essential input at
24 cost? Is that your testimony?

25 A That is my testimony, yes.

26 Q Dr. Schmalensee, what is your understanding of
27 the Commission's view of milestones as set forth in the
28 issues delineated to be addressed in this proceeding?

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

99

1 A My understanding is that the Commission posed
2 a question regarding whether there are appropriate
3 milestones. The question is cited in the attachment to
4 my prepared testimony. I believe it is probably cited
5 twice. The Commission raises the question of whether
6 milestones are appropriate or something of that sort.

7 Q So would it be fair to say that by milestones
8 the Commission is requesting recommendations from the
9 parties as to what steps, if any, should be taken either
10 prior to and in conjunction with recommended
11 modifications of the current incentive regulation
12 structure?

13 A I will go back to denying telepathic powers.
14 I don't know what the Commission intended. I took those
15 words to mean, to relate to the specific issues
16 addressed here; i.e., most particularly the first of the
17 three questions having to do with the GPD-PI minus X
18 regulatory framework or price formula.

19 I did not, as I think this indicates, and my
20 initial testimony indicates, did I not take this to be a
21 sweeping inquiry on the general nature of regulatory
22 reform.

23 Q But as I understand your testimony, you did
24 believe that the issue of milestones were raised in
25 connection with the elimination of the GDP-PI minus X
26 from the current price cap formula?

27 A The three questions say what they say. One of
28 them has the word "milestones" in it. So I assume that

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

100

1 the word milestones had some relevance to this phase of
2 the proceedings, yes.

3 Q You would -- so under that scenario, there
4 could be several modifications or milestones proposed --

5 MR. GOLABEK: I am going to object, your Honor, of
6 Mr. Brown trying to build up through this witness what
7 the Commission meant in terms of milestone so that when
8 we get around to discussing the motion to strike later
9 on he can sort of point to a witness and say, well, he
10 agreed that milestones, backdoor our proposals about
11 essential pricing input and everything else at that
12 point.

13 That seems to be where he is going, and I
14 would object to doing it through this particular
15 witness. The Commission meant what it meant in terms of
16 what milestones were or what issues it was going to look
17 at in this proceeding.

18 MR. BROWN: Your Honor, I wasn't planning to ask
19 this witness any further clarification on what the
20 Commission meant with regard to milestones. The line of
21 questioning that I was following was seeking to elicit
22 more of an understanding or response from the witness
23 with regard to what types of prerequisites he may see as
24 being viable in connection with some of the
25 modifications that have been proposed to the existing
26 NRF structure. So if I can just continue.

27 ALJ REED: Objection overruled.

28 MR. BROWN: Q I just have one other question on

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

101

1 that area, Dr. Schmalensee. Is it your position that
2 it's not necessary to meet the four prerequisites set
3 forth by Dr. Kahn prior to the modification of the NRF
4 framework or in conjunction with modification of the NRF
5 framework?

6 A It is my position that the removal of the
7 formula with retention of the Commission's supervisory
8 powers will confer benefits whether or not other changes
9 are made. Benefits would be greater in conjunction with
10 a full reform process. But that I see no reason why the
11 changes that I talked about and that Pacific has
12 proposed here require full-blown modification that I
13 think is desirable -- it is not required -- for these to
14 yield benefits.

15 This is a good first step down that road. It
16 also has benefits on its own.

17 Q Thank you.

18 Dr. Schmalensee, is it your understanding that
19 Pacific seeks modifications to the existing price-cap
20 framework in part because of the anticipated increase in
21 the degree of competition in California?

22 A Pacific's motivations are what they are. I
23 think it seeks these modifications in part on their own
24 merits and, an important part, as part of a general
25 reexamination of the regulatory framework in the face of
26 increased competition. It is certainly a linkage.

27 I would expect, however, that if there weren't
28 these competitive changes, Pacific might well make a

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

102

1 proposal of this sort, but obviously it is being done in
2 the context it is being done in.

3 Q So if the Commission were to adopt Pacific's
4 proposal in this proceeding and agreed that price-cap
5 regulation must be modified prior to the implementation
6 of steps to eliminate barriers to competition, under
7 that assumption would in your opinion that situation in
8 effect hold elimination of barriers to competition
9 hostage to the reform of price caps?

10 A These are two parallel proceedings. And the
11 hypothetical you set up doesn't have a linkage. It says
12 if the Commission decides to do this in this proceeding,
13 it could do whatever it wants to do in the other
14 proceeding. I don't -- I guess I don't understand even
15 how one could use the word "hostage."

16 Maybe I don't understand your hypothetical.
17 These are parallel. What Dr. Cornell proposes, as I
18 understand it, is that this not be modified unless. And
19 your hypothetical didn't involve any such linkage, so I
20 don't understand how the word hostage comes up.

21 Q Thank you for your answer.

22 An additional question regarding your view of
23 Dr. Cornell's testimony. You had indicated earlier
24 under cross-examination by counsel for CCTA, I believe
25 you indicated that predictability in steps that are
26 taken toward full deregulation is a good or worthy
27 policy goal. Do you remember that discussion, sir?

28 A I think I said something to that effect, yes.

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

103

1 Q Would you agree that the five steps that
2 Dr. Cornell has recommended the Commission take as part
3 of her true price caps proposal constitutes a
4 predictable approach to reform?

5 A Well, I have indicated that I have trouble
6 with characterizing the first two of these bullets, or,
7 rather, the elements of her proposal summarized by these
8 bullets, by the first two of these bullets, as
9 necessarily reform. And I must say, since it seemed to
10 me beside the point here, I didn't go through the full
11 detail of her proposal in exquisite detail.

12 It may well have been very predictable. It is
13 certainly possible to write a proposal of this sort that
14 is predictable, and she may have done so. I can't as I
15 sit here recall how definite her timetable was. But one
16 could do a predictable proposal. That is not the
17 highest of virtues, of course.

18 Q Thank you.

19 Earlier in your discussion with counsel for
20 California Cable, there was a discussion of the impact
21 of certain barriers to entry on the degree of
22 competition and the potential necessity for reform. Do
23 you remember that discussion, sir?

24 A Yes.

25 Q I believe that you indicated that it is not
26 obvious that there are huge barriers in existence to
27 high volume business technology in this state. Do you
28 remember that discussion?

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

104

1 A What I remember saying was that given that
2 there has been entry, particularly into the business of
3 providing access services to high volume business
4 customers, that the barriers to entry did not appear
5 exceptionally high.

6 Q Now, in your view, would increases in the use
7 or deployment of either wireless technology or cable
8 telephony remove the necessity for customers or, excuse
9 me, the desire for customers to retain their existing
10 telephone numbers when switching to a competing
11 provider, service provider?]

12 A Well, as a general matter, changes in
13 technology don't translate into changes in preferences,
14 necessarily. So I don't know of any reason to see why
15 new technologies would change people's preferences for
16 number portability. But that's simply not a subject
17 I studied in detail. I don't have a really good feel
18 for that.

19 Q I understood. But your general observation
20 would be that you believe that number portability, as
21 you call it, would be an important factor irrespective
22 of the increase in the use of a different type of
23 technology for provision of service.

24 A Now, let me be clear. I didn't mean to say
25 that -- to assert its importance. It's simply not
26 something that I studied. It may be important; it may
27 be unimportant.

28 What I want to say, however important it is to

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

105

1 customers, that importance is likely to be affected by
2 new technology. It is what it is, and people want what
3 they want.

4 Q Thank you. And, again, referring to your
5 discussion with counsel for CCTA in response to certain
6 questions that you were asked, I believe you indicated
7 that you see no linkage between the elimination of
8 barriers to entry in the local exchange markets and
9 reduction of the current 5 percent productivity factor
10 in the price cap formula; is that correct?

11 A What I said was that as a matter of design,
12 I didn't imply it made sense -- and Professor Wolak's
13 proposal to me was in his opinion it made sense to make
14 a link of artificial entry barriers to X factors
15 as opposed to the natural linkage, referring to pricing
16 flexibility.

17 Q Is it your position, then, that the expected
18 level of output growth for Pacific Bell does not depend
19 on the extended degree of competition that Pacific will
20 face in the local exchange market?

21 A No, that's a -- that's a different --
22 that's a different question entirely. Professor Wolak's
23 proposal had it by way of reward and punishment.

24 There certainly is a linkage, and it's
25 discussed at some length in my testimony.

26 Greater output growth generally translates
27 into greater productivity growth. To the extent one can
28 foresee -- and there's certainly reasonable grounds for

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

106

1 foreseeing at this stage -- that competition will reduce
2 Pacific's outgrowth, particularly of services that
3 in the market as a whole are growing rapidly and that
4 have been high margin services, one can expect
5 an adverse impact going forward on productivity growth.

6 I was merely saying that, as a matter of
7 design of a regulatory regime, I wouldn't -- I wouldn't
8 place sort of reward/punishment linkages in that
9 direction. I would put the linkage elsewhere;
10 that was all.

11 Q Thank you.

12 Is it your position that the extent of --
13 degree of competition in the local exchange market will
14 not be affected by either the elimination or retention
15 of artificial barriers to entry?

16 A No. As a general matter, that's not my
17 position. I think the degree of competition will be
18 affected.

19 Again, I haven't done the kind of study of
20 local competition that is presumably being done in the
21 parallel proceeding, so I can't -- I can't give you
22 the sort of detailed answer that would be appropriate.
23 But as a general matter, affecting entry barriers
24 affects competition.

25 Q Thank you. I wanted to ask you a couple
26 questions regarding a line of questioning that was
27 developed by Mr. Faber this morning.

28 In response to questioning by Mr. Faber, you

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

107

1 testified that the Commission should look to anticipated
2 or forward-looking total factor productivity growth.

3 Do you remember that discussion?

4 A Yes.

5 Q And I believe you also said that economy-wide
6 or industry-wide factors are generally appropriate, but
7 one needs to consider specific factors that also would
8 affect how well a specific local exchange carrier would
9 be expected to perform relative to the industry or the
10 national LEC industry.

11 Do you remember that discussion?

12 A Yes.

13 Q So I'd like to refer you to page 23, your
14 direct testimony, Exhibit 1 -- Attachment.

15 And I believe on -- beginning at the top of
16 this page, sir, there's a discussion of the California
17 economy and telecommunications output growth and the
18 prospects for the future in that regard.

19 Do you see that discussion, sir?

20 A Yes.

21 Q Is the purpose of the data on this page to
22 discuss the degree to which the California economy's
23 performance related to the national economy would be
24 likely to cause total factor productivity growth in
25 California to differ from total factor productivity
26 growth in the national LEC industry?

27 A Generally, yes.

28 Q And I believe you indicated earlier under

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

108

1 direct examination that the data you present here came
2 from the UCLA business forecast; is that correct?

3 I believe you made a change to one of
4 the footnotes on this page -- the footnote on this page?

5 A That's correct.

6 Q And the correction you made was to reflect
7 that the data came from the December 1994 forecast,
8 not the June 1995 forecast?

9 A That's correct.

10 Q Have you examined any more recent data in this
11 regard?

12 A Yes, I have. There was a forecast that
13 I guess made the Wall Street Journal last Friday,
14 and I have looked at those data.

15 Q Which forecast was that, sir?

16 A May I grab the story? I happen to have it
17 handy.

18 Q Yes, please.

19 A The Wall Street Journal on Friday,
20 September 22nd, covered a, I guess, UCLA forecast
21 released on Thursday, and I read the story. I've seen
22 a comparison of that -- the recently released forecast
23 with earlier forecasts, and I've seen some of the
24 disaggregate numbers from UCLA.

25 Q And, in your opinion, what was the -- what was
26 the effect of that more recent update on your
27 conclusions, as reflected on page 23, if any?

28 A Well, it makes surprisingly little

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

109

1 difference. I say "surprisingly" because if you read
2 the headline, "UCLA Sees California Outperforming
3 U.S. Economy For Many Years To Come," you would come to
4 the conclusion that there has been a complete reversal
5 of view from December '94.

6 In fact, if you look at the numbers,
7 particularly the '95 to 2000 numbers that appear
8 in Table 2 on page 23, the numbers from the most
9 recent -- the most recent UCLA forecasts are almost
10 identical. Personal income, 5.8 becomes 5.9.
11 Employment, 2.2 becomes 2.1. And population 1.2 becomes
12 1.3.

13 There's a little shift compared to the earlier
14 forecast in the timing of California's recovery from
15 the recession, so this forecast shows a couple of strong
16 years. But over the '95 to 2000 period, really,
17 personal income growth, even with continued immigration,
18 is at 2.6 percent a year; it's a stronger forecast.

19 What I think it means -- if I were rewriting
20 this paper in light of having looked at these numbers --
21 I would soften some of the adjectives in a few places,
22 but I wouldn't make any big qualitative changes.

23 This does not show -- the numbers don't show,
24 contrary to the Wall Street Journal headline, a return
25 to the '80s. There just isn't going to be that kind of
26 defense build-up, and so forth.

27 So the effect is a little smaller, but not
28 much smaller than the December '94 forecast would

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

110

1 suggest.

2 Q Thank you.

3 Now, in connection with your discussion
4 comparing the California economy to the national economy
5 on page 23 of your attachment, isn't it true that the
6 relevant issue is relative growth of California versus
7 the United States, not absolute levels of growth?

8 A That's right, for this purpose, yes.

9 Q And just to be clear, the Wall Street Journal
10 story that you have described indicates that California
11 growth is expected to outpace growth in the nation for
12 the foreseeable future, at least for the time period
13 identified in that article; is that correct?

14 A I have to go back and look at the numbers.
15 I think that's what the -- it's certainly expected --
16 you'd expected an -- expect it to outpace the nation
17 for the first couple of years, whether in fact --
18 I'm now trying to sort this out of the forecast
19 detail -- I don't think it is true in the out years.

20 I think it's true for '96-'97 as California
21 comes out of the recession finally; but in terms of
22 long-term growth trends, I don't think the numbers show
23 California -- I think once you get past this recovery,
24 California is as comparable to the U.S.,
25 not significantly outperforming the U.S., as it did
26 in earlier decades.

27 So, as I said, I think this forecast needs
28 some softening of the adjectives, but nothing dramatic.

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

111

1 MR. BROWN: If I could have a second, your Honor?

2 ALJ REED: Mhmm-hmm.

3 MR. BROWN: Just a couple more questions,
4 Dr. Smalensee.

5 Q If I understood your answer, you indicated
6 that in your view, at least for the next three years,
7 the TFP for California would be higher than the national
8 average; or is that --

9 A I didn't --

10 Q -- excuse me.

11 A I didn't say that, but we're talking about
12 economic growth.

13 Q I'm sorry. The output for California would be
14 higher than the national average; is that correct?

15 A That's what UCLA says: The output growth
16 would be higher than the national average for the next
17 two, maybe three, but I think just two years.

18 Q So for the purposes of the Triennial Review
19 that we're involved in in this proceeding, is it your
20 belief that the output for California will, during
21 the period for this review, be higher than the national
22 average?

23 A For the -- '96, '97, '98? Which three years
24 do you have in mind, sir?

25 Q Yes, sir.

26 A I think that's consistent with UCLA,
27 and I have no particular reason to doubt it.

28 Let me just -- just be clear. Yes, UCLA shows

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

112

1 for the first -- in the next three years, California,
2 in terms of -- I'm looking now at gross state product
3 versus gross domestic product comparisons, also personal
4 income comparisons -- California is a bit above
5 the nation as the whole, but for the next three years
6 California is a bit lower for this measure.

7 Q As a final clarification, in your opinion,
8 are forecasts more reliable in the closer-end years
9 as opposed to the farther-out years of the forecast?

10 A There is a saying that economists make
11 forecasts because people ask them to do it, not because
12 they can do it.

13 As a general matter, forecast accuracy
14 decreases a bit. The out-year forecasts, however, tend
15 to reflect influences -- tend to reflect effects that
16 are more stable, population trends and productivity
17 trends.

18 Near-term forecasts tend to reflect issues of
19 business cycle timing that are hard. So, it's not
20 immediately obvious that that is true, although there is
21 a tendency in that direction that near-term forecasts
22 are a bit more reliable.

23 MR. BROWN: I have no further questions, your
24 Honor. Thank you.

25 ALJ REED: Thank you, Mr. Brown.

26 Mr. Stover.

27 MR. STOVER: Thank you, your Honor.

28 CROSS-EXAMINATION

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

113

1 BY MR. STOVER:

2 Q Good afternoon, Professor.

3 A Good afternoon.

4 Q I'm Glen Stover, and I'm representing
5 AT&T Communications of California in this case.

6 Welcome to California.

7 A Thank you; it's nice to be back.

8 Q All right. I just want to draw your attention
9 at the outset to Attachment 1 to your Exhibit 1,
10 page 10, Footnote 13. This relates to the statement
11 in the text that comes after the marker foot of
12 Footnote 13: "While at the same time, its earnings
13 growth has lagged behind the national average."

14 And then you have the footnote dropped,
15 and you talk about in the footnote Pacific's changes --
16 oh, excuse me -- in the second sentence: "Pacific's
17 earnings growth has averaged 3.5 percent per year."

18 Do you see that?

19 A Yes.

20 Q All right. Now, when you were using the term
21 "Pacific" there, you're referring to Pacific Telesis,
22 the holding corporation; are you not?

23 A Yes, I believe that's correct.

24 Q All right. Turning to page 11, there's a
25 sentence at the top of the page that continues over from
26 the bottom of 10. And I would like to direct your
27 attention to the last dependent clause at the end of
28 that sentence which appears on page 11, mainly because

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

114

1 it says:

2 "The strong growth in high margin
3 services that drove productivity
4 gains in the 1980's will not occur
5 under the competitive conditions of
6 the last half of the 1990s."

7 Have you located that text?

8 A Yes. Not one of the great sentences of the
9 age, but I have it.

10 Q Could you explain for the record, please, what
11 you were referring to -- what specific services you were
12 referring to as high-margin services?

13 A This is primarily referring to the growth in
14 intraLATA toll. It is referring to the impact of the
15 onset of competition.

16 One of the reasons that it's not one of the
17 great sentences of the age is that it doesn't
18 distinguish between the market growth, which has every
19 reason to expect will continue, and Pacific's growth as
20 it faces increasing competition, and because those rates
21 were recently reduced by around 40 percent; that won't
22 continue.]

23 Q Would the high margin services that drove
24 productivity gains in the 1980s have included
25 interexchange access?

26 A For the company as a whole, interexchange
27 access was certainly a high margin -- a high margin
28 service with strong growth.

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

115

1 Whether that interstate jurisdiction service
2 is fully reflected in the cost studies that we're
3 dealing with, I'm not, as I sit here, certain. It is
4 certainly such a service.

5 Q That was a "yes" to my question; is that
6 right?

7 A Well, it was what it was.

8 Q Would you like me to have the question
9 repeated to you so you can give me a simple "yes" or
10 "no" answer?

11 A Yes, I'd be happy.

12 MR. STOVER: May we have the reporter read that
13 back, your Honor?

14 (Record read)

15 THE WITNESS: I can't give you give you a definite
16 yes or no because I'm not certain whether the impact of
17 interstate access is reflected in the Total Factor
18 Productivity growth that we are talking about here.

19 It is certainly true that, yes, for the
20 company as a whole, growth in interstate access fueled
21 productivity growth in the '80s.

22 MR. STOVER: Q I asked -- excuse me. I don't --
23 did you complete your answer?

24 A Yes.

25 Q I asked you interexchange access which is not
26 limited to interstate services.

27 A Ahh.

28 Q You referred to intraLATA toll, and I asked

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

116

1 you whether included were also --

2 A InterLATA --

3 Q -- interexchange access, which includes both
4 interstate and intrastate interLATA toll services
5 provided by other providers.

6 A I'm sorry.

7 You're correct. Inter -- intrastate interLATA
8 would be one of those services. That's correct.

9 Q Thank you.

10 May I direct your attention, please, in this
11 same document that we've been referring to, to page 26.

12 Here we're in Subsection B-1, and I would
13 direct your attention to the next-to-the-last sentence
14 in the second full paragraph.

15 The sentence beginning with the word "first."

16 Are you with me?

17 A Yes.

18 Q Great.

19 That sentence ends: "... the need for
20 regulation to control prices ... will be limited to
21 certain services" And then you identify one.

22 Would this -- would it follow from this
23 statement that you believe that "the need for regulation
24 to control prices (and provide other safeguards)" is a
25 question which should be investigated on a
26 service-by-service basis?

27 A There are -- it doesn't precisely follow.

28 If I may explain.

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

117

1 It's a decision that must be made on a
2 service-by-service basis.

3 Whether a service-by-service investigation is
4 necessarily called for or whether there are natural
5 aggregates of services that can be considered is a
6 question of really a decision-making strategy.

7 But at the basic level the decision of where
8 safeguards are necessary and where they aren't is a
9 service-by-service decision.

10 Q Right.

11 A Perhaps a location-by-location decision as
12 well.

13 Q Now, what criteria would you recommend using
14 to determine whether there is a need for regulation to
15 control prices and provide other safeguards with regard
16 to a particular service?

17 A Certainly -- and this won't be an issue long
18 in California -- but for the sake of completeness, if
19 there are legal restrictions on competitive provision,
20 then it follows that if there's only one allowed
21 provider, in most cases that calls for price
22 regulation.

23 Q That would be a regulatory barrier to entry;
24 correct?

25 A That's correct.

26 Q Uh-huh.

27 A Well, at base, if there aren't regulatory
28 restrictions, the Commission needs to reach a judgment

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

118

1 on the likely effectiveness of competition.

2 What ought to inform that judgment requires a
3 detailed inquiry.

4 But the basic principle, I think, is
5 straightforward: If competition is likely to be
6 effective -- and I would add in parentheses, I think
7 we've learned in the last 15 years or so that even
8 relatively imperfect competition tends to be -- do a
9 better job than regulation -- that if competition is
10 likely to be effective, safeguards aren't necessary; if
11 it isn't, they are.

12 Q Turning, now, to page 28 of your Attachment 1
13 to Exhibit 1, Professor, I'm looking now at the last
14 sentence on the page, the one that carries over onto the
15 following page -- actually -- I'm sorry. I'm sorry.

16 It's the last complete sentence on that page,
17 the one that begins with the word "However"?

18 A Yes.

19 Q All right.

20 You're limiting your recommendation of price
21 protection in this paragraph to Category I.

22 You are aware, I take it from the earlier
23 questions you received, that there are three
24 categories --

25 A Correct.

26 Q -- under NRF.

27 And, for the record, could you please describe
28 your understanding of what places a service in

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

119

1 Category II.

2 A I think in Category II there are no
3 restrictions, there are no legal barriers to entry. And
4 I think -- I hadn't heard the phrase, but I was given it
5 in a question earlier today, something like partially
6 competitive.

7 There are no legal barriers to entry.

8 Competition I believe has emerged.

9 Whether the Commission has more detailed
10 standards, I don't know in particular.

11 But it's my broad understanding, as opposed to
12 the specifics, that that that's an area in which the
13 Commission believes that or a service for which the
14 Commission believes that market forces are becoming
15 effective.

16 Q Do you know of any other criteria that the
17 Commission employs in moving a service from Category I
18 to Category II other than the elimination of regulatory
19 barriers to entry?

20 A Other than, of course, the criteria that it
21 implicitly employed in deciding to remove regulatory
22 barriers which must have -- which one would normally
23 expect to involve a prediction that competition would be
24 effective, I don't know of any other criteria.

25 Q Have you not heard, Professor, from your
26 contact with Pacific Bell or through your own reading of
27 Commission precedent, that the Commission has placed in
28 Category II services that either are what the Commission

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

120

1 terms "emerging competitive" or what the Commission
2 calls "discretionary"?

3 Are you not unaware of that?

4 A I'm unaware of the terminology.

5 Q Thank you.

6 Let me pose a hypothetical, since you are
7 unaware of that.

8 Would your recommendation at the bottom of 28
9 differ if you were to be told, reliably so, that there
10 were services in Category II which were placed there
11 because the Commission deemed them to be discretionary
12 but for which there was no competition, much less
13 emerging competition?

14 A Well, you remind me of an useful principle
15 that -- that in fact I think I've adopted in other
16 contexts: That the purpose -- the purpose of utility
17 regulation, broadly, isn't to control the prices of
18 everything for which there are no substitutes. There
19 may, for all I know, be only one remaining maker of
20 hoola-hoops. Very few people would call for regulation
21 for that reason.

22 The argument, if "discretionary" has the
23 meaning that it tends to have in other connections,
24 means a product that the Commission has determined as
25 not partake of the character of a necessity, that it is
26 one that may not have identical substitutes but one for
27 which the customers have been able to manage without.

28 I tend to think, particularly in this setting

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

121

1 of new products -- I want to ask the question: If a
2 company wants to produce a new product and it is going
3 to be the only producer of that new product, should it
4 be regulated?

5 I tend to give the answer no, because to
6 regulate is going to inhibit the introduction of new
7 products, and consumers who haven't had the product at
8 all are better off having it at monopoly prices if that,
9 indeed, is the case, since they have alternatives --
10 alternative uses for their money, than not having it at
11 all.

12 So that really wouldn't change my view.

13 It would remind me of another argument for
14 removal of regulation; that is, when the product is not
15 a necessity, when customers, again, have shown one way
16 or another an ability to do without.

17 Q If, as you've postulated in your response, the
18 result of such an approach would be to permit monopoly
19 pricing of services deemed discretionary, would you not
20 agree with me that there is some possibility that the
21 carrier, given that freedom, could use the monopoly
22 profits from those services to cross-subsidize services
23 that do face emerging or otherwise effective
24 competition?

25 A Could, of course.

26 I mean they could also use profits from owning
27 gas stations or selling popcorn.

28 The question is would it have any incentive,

PUBLIC UTILITIES COMMISSION, STATE OF CALIFORNIA
SAN FRANCISCO, CALIFORNIA

122

1 and I see nothing that would give it that incentive.

2 Q You've testified -- I'm looking at one
3 example, but I -- I don't wish to have everybody shuffle
4 through the papers -- about the importance of meeting
5 imputation requirements. Correct?

6 I mean I can give the reference, but would you
7 just concede that you have discussed that and you've
8 agreed --

9 A I've endorsed Professor Kahn's discussion of
10 that --

11 Q Thank you.

12 A Yes. In general terms.

13 Q Thank you.

14 And I take it that the practical effect of
15 that in a market where one carrier provides both
16 wholesale inputs that competitors use as well as the
17 retail end product -- it provides both of those -- where
18 its competitors provide only the retail output, that
19 imputation would dictate more or less as an arithmetic
20 proposition that wholesale services in the construct I
21 just gave you would be set below the retail price.

22 A Unless I'm missing something very subtle, it
23 would dictate that, yes.

24 Q Now, I'm a little unclear -- let's -- let's
25 turn to page 13, Section B.

26 I'm just a little unclear about the meaning of
27 this first paragraph under B.

28 Do you think that the past adjustments -- the